China – a risky opportunity

This issue of Focus presents an overview of China, its stock markets and its banking system. We are now working on an additional, special issue of Focus, covering the Chinese non-life and life insurance markets and the pensions market.

There are many ways to characterise China in the 21st century, but to my mind there are three factors that have to be considered when exploring the opportunity it may offer.

First, the potential scale of its markets is huge and often difficult for Europeans to fully comprehend. There are significant market opportunities in China.

Second, the Chinese view of financial products is developing and we cannot assume they view financial products in the same way as Europeans. Nonetheless, as wealth increases, the demand for saving/investment and protection products (albeit possibly not products that are exclusively protection based) will also increase.

Third, as China moves from a planned to a market economy, it would be naive in the extreme to underestimate the continuing political influence on the market and business arenas.

If these factors are borne in mind, then there will be few other economies that offer the same potential for new business growth in the financial sectors.

Good fishing.

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Background to the Chinese economy

No matter what the measure, China is an increasingly impressive economy. Since its open-door policy started in 1978, its average annual growth rate of GDP has been 9.3%, and it has now become the second largest economy in terms of purchasing power. It has a population of around 1.3bn people and it is gearing up its private economy, with the number of private enterprises now reaching 2.2 million. A further indicator of the changing nature of China is that it is now the fifth most popular tourist destination and the World Tourist Organisation forecasts it will become number 1 by 2020. Quite simply, it is an economy we cannot afford to ignore. However, we also need to realise it is still in many aspects a poor, developing country with a complex mix of political and economic systems. Those who do not pay sufficient attention to the very different nature of Chinese systems have the potential to be badly burnt and this is partly reflected by the trends in foreign direct investment (FDI).

After a heavy bout of FDI in the early 1990s ($111bn in 1993), new signings began to dry up in the late 1990s, and were down to $41bn by 2002. Foreign investors had grown frustrated by the difficulties of making their Chinese investments profitable: opaque policy procedures; sudden changes in policy; restrictions on business activity; poor infrastructure; issues over foreign exchange and the remittance of profits, all made doing business difficult. Well-seasoned foreign investors had also learned that China is a highly fragmented economy in which investment rules and procedures (and consumer markets) vary widely from city to city and province to province. One characteristic that surprised most observers was how quickly major urban markets on the coast became saturated and extremely competitive.

Nonetheless, FDI flows seem to have turned the corner over the last year, reflecting the cautious optimism that has emerged in the foreign community in China. While entry into the World Trade Organisation (WTO) has been a contributory factor, its short-term impact should not be over-estimated - the official and unofficial rules of running a successful business in China will not change easily or quickly. The potential impact of China entering the WTO can be summarised under the following headings:

Legal limits of foreign investment - China's updates of its foreign investment laws and regulations are unlikely to affect the major features of the country's foreign investment structures: representative office; joint venture; and foreign invested share company, etc.;

Intellectual property rights (IPR) protection - one reason why China's entry into the WTO has been greeted with some enthusiasm is that IPR protection will have to be enforced more rigorously;

Human resources - the difficulties of hiring and keeping valuable employees have plagued foreign companies for years. Against substantially lower wages (approximately 1/50th of those in the US), there is also substantially lower productivity (1/25th of that of the US). However, those companies that can harness the intellect and diligence of the Chinese in an organisational setting have a powerful competitive resource.

Relations with Government - an important factor in being successful is developing relationships with key policymakers in China's government, at both central and local level.

If China is able to seize the opportunity from importing technology and investment from the rest of the world then it has the potential to achieve a 7% to 8% annual GDP growth rate over the coming couple of decades. But we should not forget that this is only potential. In order to bring this potential into play China needs to do a lot of things. More specifically, it needs to:

Complete the transition from a planned economy to a market economy,
Strengthen its financial system;
Harden the budget constraints on State owned enterprises (SOEs);
Improve corporate governance;
Mitigate regional income disparities between urban and rural areas; and
Improve environmental sustainability and maintain internal/external stability.

Comment

In terms of stability, there are some risks we should all be aware of. First, if significant growth in GDP does not materialise then this could have serious consequences as employment in private companies would be stalled and the costs of an already high level of unemployment exacerbated. Second, low GDP growth would add to China's fiscal liabilities. There is the need to support the four large State banks (which have bad loans amounting to 60% of GDP, although this figure is subject to debate) and pensions (seen as equalling 70% of GDP). In other words, total government liabilities are likely to exceed 150% of GDP and this needs to be pared down via tax receipts from a healthy, growing economy. Third, in this type of situation there is always a risk of a banking crisis and deflation as consumers start to hoard.

In many ways China could be compared with Japan and its poor banking practices, hesitant consumer spending and rising government debt. The one substantial difference, and this should not be underestimated, is that the Chinese elite have signalled their desire to be a world player and the reforms needed to make this happen are easier to achieve in an authoritarian system!

All in all, China is an economy with huge potential and significant risks, and we are likely to kick ourselves if we ignore it.

Chinese stock markets - features, myths and opportunities

This article analyses Chinese stock markets from the perspective of their special features, the recent myths of their size and nature and the opportunities they create for overseas investment specialists.

Features special to Chinese stock markets

Chinese stock markets serve State owned enterprises - almost none of the companies traded on China's stock exchanges are private enterprises. In addition, government priorities dictate the approval process and there is a legal requirement for three years of continuous profitability before a listing can be approved. Overall, promising start-ups will struggle to gain access to equity via a listing;

The problem of unlisted shares - listed companies in China are 'publicly' owned through their unlisted shares. When an SOE converts to a joint stock company, only about a third of its shares are issued to public investors, the rest remain in government hands via State owned shares or 'legal person' shares. Chinese stock exchanges are not markets for corporate control;

They are not international markets - China's currency (renminbi) is not freely convertible, foreigners cannot trade 'A' shares and Chinese citizens cannot use their home currency to buy overseas equities;

Shifting regulations and control - the Shanghai and Shenzhen exchanges were only established in 1990 and the nature of regulations continue to change and reflect how the government wishes to control the equity markets;

Corruption and revolution - given the recent history of China, it is perhaps not surprising that most commentators acknowledge that corruption is rampant in its emerging stock markets. In the past, China has relied on government fiat, secrecy and personal connections, whereas effective stock markets require the rule of law, transparency and the interaction of private parties.

These points indicate the Chinese stock markets are indeed quite different in nature from those we are familiar with in the west and this needs to be borne in mind when evaluating the opportunity they offer.

Chinese stock market myths

Given the size of the Chinese economy and the rapid pace of its transformation, it is perhaps not surprising that a number of myths have arisen.

The first myth to explode is the size of the market. It is often mentioned that there are 65m share accounts in China. This number falls dramatically to somewhere between 10m to 20m individual investors when allowance is made for individuals having multiple accounts. Individuals have tried to make the most of the privatisation of SOEs by falsely opening large numbers of multiple accounts. If the number of actively traded accounts is considered, the number may be as low as 3m.

The second myth is that the stock markets are replacing banks as the primary source of enterprise finance. This is simply not true, with the banks still providing about 12 times more finance to businesses than the stock markets.

The third myth that listing SOEs has a beneficial effect on their performance is not supported by the decline in average earnings per share and average return on net assets.

Despite these myths, it should not be forgotten that Chinese stock markets have a promising future if the issues of transparency and control can be tackled. The Chinese government needs active and vibrant stock markets if it is to tackle the shift of enterprise from public to private hands and the looming pension problem.

The opportunity offered by Chinese stock markets

The China Securities Regulatory Commission (CSRC) enacted new rules, from the 1st July 2002, that allow foreign financial firms to acquire stakes in Chinese fund management and securities companies. Foreign firms are enthusiastic about entering China's securities markets and have already signed a number of technical co-operation agreements.

However, the new rules limit the amount of 'access'. Foreign investment in fund management companies may not exceed 33% and this cap will only rise to 49% in December 2004. Foreign investment in security companies is limited to 33%. In addition, there are stringent capitalisation requirements and the CSRC may impose further prudential requirements. Essentially, the various requirements reveal that China is seeking investment from foreign financial firms with industry experience. This is how China has operated most of its markets - it grants limited market access in exchange for capital, technology and know-how that will help the country develop.

Comment

While foreign investment is, in general, eagerly sought in China, there are a number of obstacles facing fund management and securities companies. Such companies face ownership caps, business scope restrictions (they cannot invest in certain types of shares) and a limited pool of qualified Chinese partners. Moreover, investors establishing ventures under the new rules will be joining a party already in progress and creating a significant footprint in China's immature/turbulent stock markets will not be an easy task.

Banking's evolutionary development in China

Around the globe and throughout history, banking systems have developed as conduits for the transfer of wealth and resources, acting as arterial systems to sustain economic activity. The gradual transfer of China's economy from State control to a market-based system continues to necessitate a parallel transformation in its banking sector.

The historic Shanxi Banks of the Qing Dynasty dominated Chinese banking until the end of the 19th century. However, the Republic of 1911 promoted the establishment of two government-owned banks - the Bank of China and the Bank of Communications. Foreign banks had also grown in importance in China since the mid-1800s and were developing a dominant position in the early 20th century. China established a third State bank, the Central Bank of China in Shanghai in 1928, and in 1935 added the Farmers' Bank of China. With the founding of the People's Republic in October 1949, the new People's Bank of China (PBC) assumed all former Chinese and foreign banking functions. The PBC maintained its monopoly on banking until 1979.

The four specialist banking arms of the PBC - the Bank of China (acting as foreign-exchange specialist); the Agricultural Bank of China (serving the agriculture sector); the People's Construction Bank (infrastructure financing); and (from 1984) the Industrial and Commercial Bank of China (ICBC) - began to function as commercial banks in 1995. These four State owned banks control approximately 85% of all commercial bank assets, have around 250,000 branches and are staffed by some 1.6m employees. Share-ownership commercial banks have also now emerged in the economy, with various government agencies and Chinese institutions holding the shares.

During the planned economy (not a free-market), the State owned banks resourced the large State owned enterprises (SOEs), a policy that has resulted in these banks now holding vast amounts of non-performing loans (NPLs). Estimates of the ratio of NPLs in 2002 ranged from an official level of 23%, to some 35%. By international standards of capital adequacy, the four State owned banks are effectively insolvent. Furthermore, large volumes of NPLs have already been transferred to State owned asset management institutions in an attempt to limit the banks' levels of bad debt. Despite recent policy reforms that target banks to reduce NPLs, economic policy still directs lending to SOEs in order to maintain employment. As a result, the banking system still acts to drive assets from private savers to SOEs. The impact of the potential banking crisis go beyond the big four State banks. Everbright Bank, China's largest semi-privatised bank, has introduced a rule allowing no more than 5% of deposits to be withdrawn in a month in order to limit liquidity pressures.

Foreign banks are gradually regaining access to the Chinese market in two ways. They may now open branches in China, but the approval process is tortuous. To date, they have been mostly limited to the major coastal cities where they offer foreign exchange services to Foreign Direct Investment (FDI) enterprises. Since 1997 some foreign banks, initially only in Shanghai and Shenzhen, but subsequently in certain other provinces, have been allowed to conduct limited domestic currency business to foreign-funded enterprises and take part in syndicated lending. To date, foreign banks have been extremely limited in their dealings with wholly domestic firms and individuals.

An alternative approach has been for foreign institutions to obtain stakes in some smaller commercial banks. Citigroup won approval to buy a 5% stake in Shanghai Pudong Development Bank; one of four listed Chinese banks. HSBC already holds an 8% stake in the Bank of Shanghai, and is said to be in talks with other regional banks. US investment group, Newbridge Capital, has a 20% stake in the

Shenzen Development Bank. Fujian Industrial Bank, a medium sized commercial bank, is also said to be talking to potential foreign investors. In a move of perhaps greater significance, the Bank of China itself, currently 100% owned by the finance ministry, is set to offer equity stakes to foreigners in a move to amend the bank's ownership structure prior to a planned Shanghai stock market listing around 2005. Standard Chartered Bank already has a small stake in the bank's Hong Kong arm.

A significant range of concessions to the banking industry came through China joining the World Trade Organisation (WTO) in December 2001. The concessions allow that foreign banks will be permitted to conduct domestic business with local corporates within two years of China's accession and with individuals within five years. Geographic barriers will also be removed over the next three years. New entrants are likely to attempt to cherry-pick wealthier individuals. The new middle-income urban household segment is doubling every two years. After 2007, competition for mortgages, car finance, education loans and credit cards is expected to be intense.

Comment

The WTO reforms should ultimately allow foreign banks greater freedom and enable Chinese customers to access the financial services that they want. However, despite the WTO negotiations, the State retains significant control over the operation of bank activities. For example, the one branch per city rule for foreign firms will continue to limit foreign bank branch networks. Additionally, the PBC stipulates rules on balance sheet composition, such as limiting the ratio of domestic deposits to foreign currency liabilities, or the ratio of domestic interbank borrowings to assets. Foreign banks may have better luck attempting to introduce products through domestic institutions in which they have an investment. One advantage may come from the introduction of technologies in order to 'leap frog' the need for branch based distribution. HSBC and Hong Kong's Bank of East Asia now have licences from the PBC to begin online banking in China.

Further issues that still need to be resolved include accounting standards and the legal framework underpinning ownership and loan enforcement mechanisms. Perhaps the most important evolutionary step of all will be the separation of the banking sector from central industrial policy. Commercial banks will only come to dominate in an environment and economy which values the efficient allocation of capital. To see this step-change, the big four State banks may well have to be deconstructed and go the way of the dinosaur.

The opinions in Focus on Finance are those of the authors alone.

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